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SUBJECT: LEBANON: BANKS COMMISSIONER WORRIED ABOUT BANKS,
SEEKING SOFTER U.S. SUPPORT FOR THE CURRENT GOL

Classified By: Ambassador Jeffrey D. Feltman for reasons 1.4 (b) and (d)
) .

SUMMARY

1. (C) In a February 13 meeting with the DCM and visiting NEA/ELA Office Director, the head of Lebanon's Banking Control Commission, Walid Alameddine, expressed concern about the effect of the summer war on banking sector stability. Alameddine believes the GOL should not expect a large contribution from the banking sector for official debt reduction. He also argued for an easing of U.S. policy on implementation of the international tribunal and toward Syria. Finally, Alameddine suggested that the current government is not actively pursuing economic reform, implying that the U.S. should reconsider how strongly it supports the Siniora cabinet. End Summary.

CONCERNS IN THE BANKING SECTOR

2. (C) DCM, NEA/ELA Office Director Abercrombie-Winstanley, and Econoff met with the chairman of the Banking Control Commission (BCC), Walid Alameddine, on February 13. BCC figures collected from the banks show that banking sector profits were USD 670 million in 2006, less than a 1 percent return on assets of USD 80 billion. The return on capital remained static from a year earlier at 11 percent, despite a 30 percent increase in capital over the first six months of 2006. By contrast, Alameddine pointed out, the return on capital for international banks is 18-19 percent. The July war led to losses in loan portfolios of about USD 100 million; those losses could have been much larger but the banks' exposure to the south and the Biga' were small. The July war caused an additional USD 90 million in lost income in banks' bond portfolios, as the value of the bonds they held decreased. These losses are reflected in banks' capital, rather than in their profits. The BCC is currently running stress scenarios ahead of a February 15 meeting with the IMF; the BCC expects another USD 200 million in losses in 2007 from the economic slowdown if Lebaon's political stalemate continues.

3. (C) Also worrying is the drop in banking system liquidity, from USD 9 billion to 8 billion. Not all 60 Lebanese banks have been affected equally by the July-August war, and the central bank, Banque du Liban (BDL), had to provide to two banks, one large and one small, foreign exchange liquidity, even though the BDL is the lender of last resort in local, not foreign, currency.

EXPECT A LIMITED BANK
CONTRIBUTION TO PARIS III

14. (C) alameddine acknowledged that it is important that the market see banks contributing something to Paris III's success, but it is still unclear what the GOL expects of the banks. Their anticipated role must be adjusted downward in light of consequences of the summer war. After Paris II, Lebanon's commercial banks subscribed to USD 4 billion in zero interest bonds, which had a USD 400 million a year impact, but were able to transfer some of this impact to their depositors through decreased interest rates. Today the situation is very different; contrary to expectations, Paris III steadied but did not reverse the outflow of deposits or diminish the level of local currency to foreign currency conversions. The level of outflows and conversions remains higher than after the Hariri assassination, indicating that people are more worried about the current economic and political situation, perhaps because of the riots that took place in late January just before Paris III, when people had been expecting improvement rather than another round of violence and instability.

LOBBYING FOR A CHANGE IN U.S. POLICY

15. (C) Alameddine emphasized several times that he was sharing this worrying data with USG officials in order to emphasize the need for U.S. assistance in helping Lebanon break out of its political impasse. "The fact that the market hasn't responded to Paris III shows that Lebanon's greatest need is for political reconciliation," Alameddine told us. The indiscriminate terrorist killing of civilians

BEIRUT 00000252 002 OF 003

from all walks of life can't go on. He noted that the mother of one of his direct employees, who is an Aoun supporter, was on one of the two public commuter buses that were bombed on February 13.

16. (C) An exit from the political impasse would allow Lebanon to capitalize on Paris III economically and politically. While the more than USD 1 billion in budget support made available to the GOL at Paris III is significant, it is not enough to cover the deficit, much less to reduce debt. Therefore, Lebanon needs political stability to allow a private sector boom to help reduce debt. Lebanon should be the best positioned country in the region to take advantage of Gulf and Iraqi refugee investment. Before the July war, Lebanon had seen the largest inflow of bank capital in its history, and nearly all was from Gulf sources.

17. (C) Even if the USG must compromise, he added, Lebanon is already a success story for USG policy: the Syrians have withdrawn; the army pushed Hizballah out of the south; and the GOL held Paris III successfully. The current recession only benefits Hizballah, but with greater political stability a pro-U.S. Lebanon will marginalize Hizballah through growth and job creation.

18. (C) The major obstacle to a political reconciliation is the Special Tribunal, and "it is important as a deterrent for future violence, but not THAT important." With the Syrians already withdrawn and Hizballah already out of the south, the Tribunal card should not be overplayed as a U.S. tool against Syria. The Tribunal should focus on the Hariri assassination only, rather than on bringing down the Syrian regime. It should be used with limits, rather than as a politicized entity. Its usefulness is past its peak, and diminishing further.

WEAK LEADERSHIP AFFECTS
FINANCIAL SECTOR HEALTH

¶9. (C) Alameddine used his criticism of the government's economic management to hint that the U.S. should not be too supportive of the Siniora government. The Prime Minister is not proactive, Alameddine argued, while the U.S. is a country of action. Weak leadership is affecting financial sector health, Alameddine told us, because Finance Minister Azour and Siniora are too fixated on the political situation to pursue economic reform. "It's not (Hizballah SYG) Nasrallah holding back reform, its the majority!" Alameddine told us.

¶10. (C) Alameddine made four points on the GOL's economic management. First, the BCC's stress scenario shows that some banks need to be bailed out, and for that a banking sector merger law is needed. But a draft law already approved by Parliament has been sitting on the Prime Minister's desk for over a year, awaiting a second Cabinet approval, on the mechanism of its implementation. PM Siniora is stalling on the implementation, Aladeddine said, because he had problems with the Governor of the central bank over implementation of a previous law and wanted greater control over the process. Desperation is driving a few banks to take unorthodox measures to stay in business. One small bank with capital of just USD 70 million picked up some new clients the chairman had met in a Rome hotel lobby in a transaction that looks like money laundering. Had there been a new bank merger law in place, this bank could be bought out by a larger competitor. The USG could provide a consultant or, through messages from Treasury and State Department, push the Prime Minister to finalize the law and enable the mergers to go forward to strengthen the banking system.

¶11. (C) Second, the current government has not provided adequate regulation to develop the financial system. It has not passed a law to govern the stock exchange, which has just USD 8 billion in capital while the banking sector has USD 80 billion; in better regulated financial systems the two should have approximately equal capitalization. People are unwilling to invest in the capital markets without a law, and poorly regulated initial public offerings have caused investors to lose money, eroding the credibility of the stock market. The GOL has also failed to provide judges with the expertise to try financial cases.

¶12. (C) Third, GOL debt management has been weak, and the BDL has taken over a role the Ministry of Finance (MOF) failed to follow through on. As a fourth area of government

BEIRUT 00000252 003 OF 003

failure, Alameddine said the GOL must take more concerted action to privatize the electricity sector.

FELTMAN